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TAGS: ECON EFIN ETRD EINV PREL PGOV CH
SUBJECT: CHINA ASSET BUBBLES: ARE THEY HERE, WILL THEY POP?

REF: A. SHANGHAI 34
¶B. 09 BEIJING 3191
¶C. SHANGHAI 22
¶D. 09 BEIJING 3421

Classified By: Deputy Economic Chief Robert Forden; Reasons 1.4 (b, d)

¶1. (C) Summary. China's massive 2009 monetary stimulus program was instrumental in avoiding economic recession during the global crisis, but the huge amount of new credit flowing into the economy has prompted concerns that asset bubbles could form -- and burst -- in the property and equity markets. Since the start of 2010, China's monetary policy agencies accordingly have begun to tighten credit availability, raising the reserve ratio requirement and announcing other regulatory measures. In the booming real estate market, which played a key role in keeping the economy booming in 2009, housing price increases accelerated late last year, prompting Premier Wen Jiabao and the State Council to announce a slew of new lending, taxation, credit, and land policy measures to cool the market. Official concern escalated when new lending reached RMB 1.1 trillion (USD 160 billion) in the first two weeks of January, well above the government's desired pace. With demand for new housing for various reasons likely to continue to expand in 2010 and beyond, the possibility of bubble formation is likely to increase by late-2010 or early-2011. For China's historically volatile stock markets, price-earnings ratios have climbed sharply over the past year, but officials appear less concerned. End Summary.

¶2. (C) Comment: Analyst opinions about the likelihood of bursting bubbles vary, but most believe that despite some worrisome data, the government is monitoring the situation closely and has the means to avert any catastrophic crashes in 2010 (ref a). The stock exchanges will be volatile, with sharp short-term changes, but the analysts believe the underlying economic fundamentals largely remain sound and will propel share prices on a bumpy yet upward ride. For real estate, the bubble would be larger and the negative consequences potentially greater, but the People's Bank of China (PBOC) and other regulators are able to employ an array of micro-control measures, including interest rate adjustments and down payment requirements that can vary by city, to cool off individual over-heating markets. End Comment.

Background

¶3. (SBU) Economic bubbles, generally defined as trade in high volumes at inflated values, or as too much money chasing too few assets, have appeared in a variety of countries at

different developmental stages, often due to excessive liquidity in the financial system. In China, concerns about the potential impact of the global financial crisis prompted the government in late-2008 to implement massive monetary and fiscal stimulus programs, including removal of bank lending quotas. As a result, in 2009 Chinese banks issued USD 1.5 trillion in new credit, roughly double the previous record set in 2008. While most of this money apparently reached its intended destinations -- infrastructure projects, industrial investment, and to a lesser extent programs to encourage consumption -- analysts estimate there was substantial (e.g., twenty percent) "leakage" into, among other places, the equity and real estate markets.

¶4. (SBU) This "leakage" would not attract too much official attention as long as it did not generate other significant problems, such as inflation and/or asset bubbles, which could in turn lead to the dreaded "social instability." Inflation and asset bubbles would not necessarily appear together, but policy measures to address them generally would overlap. Inflation, because it has helped spark social instability in the past (e.g., 1989) and presumably could do so again, is a key concern of the Chinese Government. Senior leaders and financial regulators monitor price indices closely for any signs of imminent escalation. Through most of 2009, as the banks -- at the government's behest -- pumped stimulus money into the economy, consumer price changes hovered around zero, only turning slightly positive in November. In early January, unusually cold weather and heavy snowfalls in northern China led to a sudden jump in food prices. Beyond that temporary phenomenon, however, surging economic growth and rebounding exports have led some forecasters recently to

raise inflation predictions for 2010 to 3.0-3.5 percent (versus 2-2.5 percent previously). While low by developed country standards, this level of inflation in China is sufficient to prompt official concern and monetary policy tightening.

Government Intervenes

¶5. (SBU) Since the start of 2010, China's monetary policy agencies have begun to tighten credit availability. On January 12, the PBOC raised the reserve ratio requirement (RRR) by fifty basis points, to 16 percent for large commercial banks (accounting for more than half of total deposits) and 14 percent for small banks, effective January 18 (rural credit cooperatives were exempted). Analysts believe the move was triggered by the early-January surge in bank lending, which the government's actions sharply slowed over the last ten days of the month. The RRR increase -- the first since June 2008 -- was welcomed by most economists, who believe it signaled the beginning of monetary policy "normalization" by removing excess liquidity and containing the risk of asset inflation and bubble formation. Such a small raise in itself would not have much affect, but the action implies further tightening measures in the next few months, including more RRR hikes, direct credit controls through "window guidance" to slow bank lending, restrictions on investment in sectors with excess capacity, and perhaps even price controls if food prices continue to rise.

Real Estate

¶6. (SBU) 2009 was a boom year for China's real estate sector, which played a major role in compensating for the export slump. In addition to some specific stimulus measures for real estate introduced in late-2008, two other macroeconomic factors boosted prices in 2009. First, the enormous monetary stimulus caused money supply to increase much faster than GDP, with a considerable portion of the excess liquidity flowing into the asset markets, including real estate. Second, in the wake of a slow-down in new construction since mid-2008, officials and consumers alike were concerned about rising prices and a potential supply shortage. Beyond these

factors, low mortgage interest rates and low overall taxation on property purchase and ownership make property investment an attractive proposition for Chinese consumers. According to the China Banking Regulatory Commission (CBRC), real estate development loans and individual home mortgages now constitute twenty percent of total bank loan balances. Also, large volumes of overseas investment and "hot money" are believed to have poured into real estate investment over the past year.

¶7. (SBU) In late-2009, officials began to worry that bubble trouble was imminent for the real estate sector. Controlling inflation, including property prices, was a major topic of the December Central Economic Work Conference in Beijing (ref b). November data on housing starts and property sales, presumably available to officials before that conference, showed huge jumps over October and compared to one year ago. Prices accelerated even more in December, rising at the fastest pace in eighteen months, according to the National Bureau of Statistics (NBS). Housing prices in seventy large and medium cities surveyed increased 7.8 percent in December (y-o-y), contributing to growing fears of a bubble in the sector. The cities with the most rapid increases were Guangzhou, Shenzhen, Haikou, and Beijing. NBS attributed the December rise to record bank lending levels in 2009, favorable policies, and speculation. For all of 2009, residential housing sales rose 35 percent from 2008, while average sales prices jumped 16-27 percent in major cities.

Cooling the Market

¶8. (SBU) In late-December, Premier Wen Jiabao said his government would attempt to moderate rapid growth in the real estate market through taxation, credit, and land policy measures. Next, the State Council re-imposed a 5.5 percent tax on transactions involving residential property held for less than five years. On January 7, the State Council issued new regulations and orders to cities with rapidly rising housing prices. It directed the municipal governments to take steps to increase housing supplies for low-income residents, and to prevent developers from hoarding land or withholding housing from the market to drive up prices (ref c). On January 10, the State Council also instructed the

PBOC and the CBRC to tighten oversight of bank lending for real estate purchases.

2010: Will the Bubble Burst?

¶9. (C) According to UBS Chief Economist Wang Tao, for 2010 and beyond, the need for new housing likely will continue to grow rapidly, due to rising incomes, substantial pent-up demand, and the government's recently announced intention to facilitate more rural-to-urban migration (ref d). The Government apparently intends to increase the supply of mass market housing, especially in smaller cities, while also seeking to reduce property-related lending that fuels speculation. While a strong increase in supply could slow price rises, Wang believes "exuberant expectations" of price rises together with still-plentiful liquidity and the other incentives noted above could continue to push demand, possibly leading to a bubble in late-2010 or early 2011.

Stock Markets

¶10. (SBU) Since their inauguration in the early 1990s, China's stock markets have been highly volatile, in part due to inexperienced investors eager to take quick profits. China's equities markets rose eighty percent in 2009, with considerable volatility at various times. Overall, China's capital markets raised 447 billion RMB (USD 65 billion) in 2009, the second highest total on record (after 2007). For stock markets, one indicator of bubble formation would be share prices misaligned with company earnings. For shares listed on the Shanghai Stock Exchange (SSE), the current

price-earnings ratio is around 28, somewhat high compared to developed country markets but in line with the SSE's historical levels. What prompts bubble worries, however, is that in October 2008 the SSE P-E ratio was just 14, so it has doubled in just over one year.

What About the RMB?

¶11. (SBU) Some analysts believe the January 12 RRR increase announcement was prompted in part by December's sharp rise in exports, which heightened speculation that RMB appreciation -- on hold since August 2008 -- might resume sooner than previously expected. Asset bubbles, however, further complicate this policy decision: if many investors become more concerned about bubble formation, they could seek other investment alternatives. As such options are extremely limited in China, those investors might seek to place their funds outside China. Expectations of significant near-term currency appreciation, however, will generate uncertainty and confusion in the market.
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